

into unregulated long distance services would increase incentives to cross-subsidize and to engage in other anticompetitive strategies to evade continuing local service regulations.⁹²

3. The likelihood of anticompetitive behavior based on cross-subsidization of interLATA markets increases.

110. The BOC can easily cross-subsidize its long distance operation (or its long distance affiliate) by not requiring its long distance affiliate to pay the full cost of the inputs it uses. For example, the long distance operation of the BOC will use the brand name of the BOC, one of its most important assets, without payment -- clearly cross-subsidization. Further, it is not clear how the costs will be divided in the joint marketing of the long distance and the local operations, raising the possibility of additional opportunities for cross-subsidization.

4. The likelihood that the BOC will cooperate with local exchange entrants, as required by the Act, decreases.

111. Entry by a BOC into interLATA services results in a fundamental change in the BOC's incentives to discriminate among long distance carriers. When the BOC is restricted to

⁹² Indeed, BellSouth's economic witness Glenn A. Woroch acknowledges that "[t]here are several potential anticompetitive practices which an integrated ILEC such as BellSouth might theoretically take." *Affidavit of Glenn A. Woroch on Behalf of BellSouth*, in the Matter of Application of BellSouth Corporation, BellSouth Telecommunications, Inc., and BellSouth Long Distance, Inc., for Provision on In-region, InterLATA Services in Louisiana, Before the Federal Communications Commission, page 23 (November 1997); see also *id.*, at page 8 ("Strategic behavior by an ILEC would become a concern . . . were its control of bottleneck network services is used to discourage entry into downstream markets, especially retail local exchange and long distance.")

offering local services, the BOC has no incentive to favor one long distance carrier over another. Because local access and long distance are complements (*i.e.*, a local loop is required to complete a long distance call), the BOC has an incentive to encourage as much long distance competition as possible. Competition in long distance drives down toll charges, stimulating demand for long distance services. In turn, BOC revenues increase both because of increases in access revenue -- which significantly exceeds the incremental cost associated with the traffic -- and because consumers who pay less for long distance service are likely to be willing to spend more on local services.

112. Once a BOC is also a long distance carrier, it has a strong incentive to discriminate in favor of its own long distance business. Before entry, local and long distance are complements; after entry, the BOC and other long distance carriers are competitors, and thus the BOC will lack the necessary incentive to provide services to the interexchange carriers, which the latter require in order to compete with the BOC both as a competing local exchange carrier and as a long distance carrier.

5. Costs of regulatory oversight to protect consumers and the competitive process and delaying the development of local competition rise.

113. The most important social cost of premature BOC entry into interLATA services is likely to be the forestalling of the emergence of effective local competition. Implementing the pro-competitive policies of the Act is quite difficult and is likely to require substantial regulatory oversight as long as the BOCs retain significant monopoly power over essential

facilities. It is important to understand that the difficulties of introducing competition into local exchange markets are likely to be significantly greater than it was to introduce competition in long distance, which explains the need for more stringent regulatory requirements such as the unbundling and resale provisions of Section 251.⁹³

114. Introducing local service competition is more difficult for at least five reasons. First, the capital investment per customer is much larger for local services than for long distance. In 1995, the investment-per-subscriber line was \$1,828 for local services compared to \$255 for that for AT&T -- a more than sevenfold difference.⁹⁴ This means that the BOC is likely to retain its role as the monopoly provider of facilities in many local markets for a number of years.

⁹³ Professor Schwartz argues that:

"In the present context authorizing BOC entry prematurely and relying solely on post-entry safeguards to attempt to open BOC local markets to competition is especially dangerous The FCC's experience with trying to pursue Open Network Architecture in the face of incumbent LECs' resistance illustrates the difficulties involved."

See *Supplemental Affidavit of Marius Schwartz on Behalf of the U.S. Department of Justice*, note 84, *supra*, page 17.

⁹⁴ See *Statistics of Communications Common Carriers 1995/1996*, Federal Communications Commission, November 27, 1996. Local exchange plant in service was \$278.946 billion (Table 2.7) and there were 152.601 million subscriber lines (Table 2.3); AT&T's total plant in service was \$25.894 billion (AT&T financial data maintained in conformance with regulatory requirements) and there were 101.357 million subscriber lines (Table 8.12).

115. Second, entry into local services requires competitors to cooperate much more extensively than was necessary in long distance markets. In local services, entrants will need to purchase essential UNEs, wholesale, and interconnection services from a competitor. During the early days of long distance competition, competitors needed to both interconnect with AT&T and lease wholesale transport facilities, but this dependence was never as great and did not last as long as the CLECs' dependence on the BOC. In the long distance context, the option to build long distance transport bypass facilities offered more effective discipline than the analogous option of local bypass in local exchange markets.

116. Third, the technology of local exchange competition means that providers have less flexibility in where they locate facilities than does a long distance carrier. To provide local loop service, a carrier needs loops that go to each house. To provide long distance service, a carrier can locate its point of presence much more flexibly; its only constraint is that it sits within the LATA. This is also true for the location of switches and long-haul transport facilities. This added flexibility in the interLATA arena lowers the costs of constructing facilities and increases opportunities for competition among facilities over a wider geographical range.

117. Fourth, with BellSouth precluded from interLATA services, and consequently interested in promoting increased long distance competition, regulators and the BOC's interests regarding the promotion of long distance competition are aligned. This alignment of interests eased the burden on regulators immediately following divestiture when effective competition

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was emerging because BellSouth is likely to have much better information about underlying costs and demand than is available to the typical regulatory agency. No alignment of interests exists with respect to local markets.

118. Fifth, the local services provided by the BOC are an essential input to a wider class of products and services than is long distance and so there are a greater array of monopoly leveraging opportunities, giving the BOC a greater incentive to preserve its local monopoly.

119. Elimination of one form of simple regulation (*i.e.*, the interLATA entry restriction) would create increased incentives and opportunities for anticompetitive strategies which would be harder both to detect and to deter. Therefore premature entry by a BOC into interLATA services would increase the overall regulatory burden on state commissions and the FCC, which already face a significant regulatory challenge promoting local service competition.

V. RESPONSE TO CLAIMS BY BELL SOUTH AFFIANTS, IN GENERAL

120. In this section, we demonstrate that the BellSouth affiants in this proceeding present misleading and logically inconsistent arguments in support of their principal conclusion that permitting BellSouth entry into interLATA services at this time is in the public interest. (In the next two sections, we respond more specifically to claims made by Professor Hausman and Professor Schmalensee, respectively.) Using faulty data, the BellSouth affiants argue that long distance prices are excessive and contend that permitting entry by BellSouth is the only

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way to introduce effective competition into interLATA services, while denying the existence of any threat to the competitive process. These erroneous arguments are based on a mischaracterization of economic theory and a selective presentation of partial or incorrect data, as we demonstrate below. Specifically, we show the following:

1. Key arguments of BellSouth affiants are logically inconsistent.
2. Basic economic theory suggests greater benefits from increased local competition, but not from additional entry into long distance markets.
3. Long distance markets are effectively competitive, and prices have declined net of access charges, contrary to arguments by BellSouth affiants.
4. BellSouth is not unique in being able to offer effective long distance competition.
5. Threat of anticompetitive behavior by BellSouth is real and supported by economic theory.

A. The Arguments of BellSouth Experts are Logically Inconsistent

121. The basic arguments of BellSouth experts are logically inconsistent. First, they argue that long distance pricing is not competitive, while regulation precludes (and, under the protective provisions of the Act, will continue to preclude) the exercise of any market power over local services. If regulation is so effective, one wonders why it was not historically effective in deterring anticompetitive behavior in long distance markets. The answer is, of

course, that regulation is imperfect and only partially restrains the incumbent monopolist.

122. In calling for a new regulatory paradigm, the Telecommunications Act of 1996 relies on the generally accepted premise that effective competition provides a better mechanism (*i.e.*, lower cost, enhanced incentives, and greater effectiveness) for assuring desirable market outcomes (*i.e.*, lower costs, lower prices, and improved customer choice) than does direct regulatory oversight. Section 271 of the Act anticipates the danger to the competitive process in all telecommunications markets of allowing a BOC to enter in-region, interLATA services prematurely, before the emergence of effective competition which will demonstrate that the pro-competitive provisions of Section 251 have been successfully implemented.

123. Second, arguments of high long distance margins are inconsistent with the empirical evidence of low entry barriers (*e.g.*, the history of robust entry) and with profit-maximizing behavior by all of the other potential entrants to the market. If excessive profits are being earned in long distance, then why does additional entry not occur? The answer is that long distance firms are not earning excess profits because prices approximate economic costs.

124. The restriction against participating in in-region, interLATA services in Louisiana applies only to BellSouth. BellSouth is unique in only one respect: It is the incumbent monopolist supplier of essential bottleneck facilities. BellSouth is not unique in being the only firm with the firm-specific skills and financial power to enter interLATA services. Potential entrants include all of the other RBOCs, cable television companies, and

all of the firms which are cited as evidence that local competition is (at least potentially) vigorous.

B. Economic Theory Suggests Greater Benefits From Increased Local Competition not Additional Entry Into the Long Distance Markets

125. Six economic features of local exchange and long distance markets highlight the likelihood of market power in local exchange and competition in long distance:

1. Local service is an essential input to the production of long distance service (that is, the price of access is a cost of providing long distance).
2. Local service demand is relatively price-inelastic, while long distance demand is more elastic.⁹⁵ Hence, with market power, local exchange markups over cost are likely to be much higher than for long distance, suggesting larger potential price declines for local exchange.⁹⁶
3. Local markets are geographically much smaller than long distance (with loops to specific residences and businesses, as opposed to transport between city pairs). Therefore, while one may meaningfully speak of a

⁹⁵ Estimates of the price elasticity of long distance demand range from around -0.5 to -0.75, while the price elasticity demand for local services is much closer to zero. See, e.g., Lester Taylor, *Telecommunications Demand in Theory and Practice*, Boston: Kluwer Academic Publishers, 1994; and Simran Kahai, David Kaserman, and John Mayo, note 24, *supra*.

⁹⁶ Traditional price regulation seeks to restrain monopoly pricing, but such regulation is imperfect, in part, because the carrier possesses superior information regarding the nature of costs and demand.

national long distance market, local services in a state are comprised of many essentially separate local markets (*e.g.*, potentially, each wire center could be regarded as a separate local market because subscribers in that wire center cannot choose among alternative sources of supply).

4. As we noted earlier, local service is much more capital-intensive, representing a potential barrier to entry into local markets.
5. Monopoly-supplied inputs are necessary to provide local service. In local service, BellSouth's network is needed for call origination and termination, switching, and transport; the cooperation of a competitor (BellSouth) is required for an entrant's success. In contrast, in long distance, there is equal access (for call origination and termination) and competitive bulk-supply for transport and switching.
6. Resale mechanisms are different in local and long distance markets. Long distance resale more closely resembles the unbundled network element mechanism of the Telecommunications Act of 1996 than local resale; unbundling of local network elements is not yet a commercial reality.

126. These industry and market characteristics strongly suggest that long distance markets are more competitive than local exchange markets. This suggestion is borne out by the empirical evidence presented in Section III of significantly more competition in long

distance than local exchange markets.

C. Long Distance Markets are Effectively Competitive and Prices Have Declined Net of Access Charges, Contrary to Arguments by BellSouth Affiants.

127. BellSouth affiants argue that consumers will derive significant benefits from BellSouth entry into interLATA services because long distance markets are not effectively competitive and prices significantly exceed economic costs. They present three pieces of evidence for this claim. First, they argue that market share patterns indicate that long distance markets are not competitive; second, they maintain that long distance prices have not declined net of access changes and that such declines as have occurred have not benefited most residential consumers;⁹⁷ and third, they argue that the costs of providing long distance service cannot exceed approximately \$0.10 per minute, and hence, prices in excess of this amount reflect oligopoly pricing. These arguments are both incorrect and misleading, as we explain below.

128. First, as we noted earlier, patterns of entry and market share trends demonstrate the vigorous nature of long distance competition, not the converse as argued by BellSouth affiants.⁹⁸ AT&T has continued to lose market share since 1989, and the loss in market share

⁹⁷ See *Declaration of Richard L. Schmalensee on Behalf of BellSouth, Inc.*, note 6, *supra*, page 10.

⁹⁸ For example, see *Declaration of Richard L. Schmalensee on Behalf of BellSouth, Communications, Inc.*, note 6, *supra*, pages 5-7.

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has not been captured entirely by MCI and Sprint.

129. Second, as we observed in section III, switched interstate toll prices fell by about 66 percent in real terms from 1984 to 1997, or by 44 percent net of access charge reductions. These price reductions were shared across services and by all classes of customers. As we explained, a narrow focus on MTS tariffs is inappropriate because such tariffs are not necessarily considered by customers when making their purchasing decisions, as demonstrated first by their actual behavior (as reflected in ARPM trends), and because of the way in which telecommunications services are actually marketed (promotional materials and advertisements do not reproduce tariff pages).

130. Furthermore, although access charges are an important component of long distance service costs, they are not the only input cost. Increases in other cost categories such as marketing-related costs or uncollectibles may offset any savings associated with reductions in access charges. Second, changes in tariff prices provide only a noisy and inappropriate estimate of changes in average revenue per minutes (ARPM), which offers a superior summary statistic for assessing price trends. There may be changes in demand patterns that make it difficult to associate reductions in access charges directly to changes in tariffed prices. If one insists on considering patterns in tariff prices, then it is more informative to consider the least-cost options for delivering service to each category of consumer (see Exhibit 6).

131. Third, assertions that long distance margins are excessive are based on incorrect estimates of costs; we respond to these assertions in detail in section VII below.

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D. BellSouth is Not Unique in Being Able to Offer Effective Long Distance Competition

132. Professor Gilbert and Professor Schmalensee argue that BellSouth is unique in its ability to offer effective interLATA competition and to deliver benefits of competition to low-usage customers. They agree that one-stop shopping will be attractive to consumers and will permit an integrated provider to realize scale and scope economies with respect to sales and marketing costs and corporate overhead. However, neither of them adequately addresses the asymmetry in the challenges faced by IXCs integrating into local services and ILECs integrating into long distance. While the former face formidable economic entry barriers, the latter are limited solely by the regulatory restriction against providing in-region, interLATA service. The challenge to introducing effective "one-stop" shopping competition is to introduce effective local competition. Until this competition succeeds, entry by an ILEC into long distance will give it an overwhelming and unfair competitive advantage; whereas, IXCs seeking to enter local services will not have such an advantage, not until they at least demonstrate that they can compete effectively in local services. Therefore BellSouth is unique because of its monopoly control over essential bottleneck facilities.

E. The Threat of Anticompetitive Behavior by BellSouth is Real and Supported by Economic Theory

133. Professor Gilbert and Professor Schmalensee argue that current regulatory safeguards against anticompetitive behavior are more than adequate to protect against future abuses. However, we have no experience enforcing unbundling and interconnection provisions

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which are as complex and as extensive as those required under the Act.

134. Furthermore, as we noted above, regulatory implementation is necessarily imperfect, and existing provisions will be significantly more difficult to enforce once the ILEC is vertically integrated. Our earlier discussion cites examples demonstrating that the danger is real.

135. With entry into in-region interLATA services, BellSouth incentives and ability to pursue anticompetitive strategies will increase at the same time that the regulatory challenge facing the Louisiana Commission is becoming more complex. Under these circumstances, the entry restriction against in-region, interLATA participation by BellSouth represents the least-cost regulatory alternative to assure that BellSouth does not abuse its market power to harm the competitive process.

136. Both Professor Gilbert⁹⁹ and Professor Schmalensee¹⁰⁰ argue that there is no evidence of anticompetitive behavior in a number of other markets in which vertically integrated ILECs compete. For example, they argue that the experience of markets where SNET and GTE operate as integrated carriers provides evidence of the benefits of allowing

⁹⁹ See *Affidavit of Richard J. Gilbert on Behalf of BellSouth Communications, Inc.*, note 7, *supra*, pages 19-21.

¹⁰⁰ See *Declaration of Richard L. Schmalensee on Behalf of BellSouth*, note 6, *supra*, pages 31-34.

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ILECs to compete in interLATA services.¹⁰¹ However, as we demonstrate in sections VI and VII below, the most important lesson demonstrated by this experience is consumer demand for "one-stop shopping."

137. With the introduction of effective local competition, it will be possible to erase the artificial distinction between intraLATA and interLATA telephone service, and consumers will be able to purchase bundles of service flexibly from multiple carriers. This combination will simplify consumer choices and will facilitate the development of innovative new services and more effective discounting programs, producing significant benefits for consumers. The success of GTE and SNET demonstrates the attraction of "one-stop shopping" to consumers. However, in the current regime, consumers cannot choose among multiple suppliers.

138. Premature entry by a BOC into interLATA services is likely to make this situation permanent by affording the BOC an unfair advantage in competing for long distance traffic and by raising local entry barriers (as we described earlier). The only entry barrier facing BellSouth -- but facing no other carrier who wished to compete in Louisiana toll

¹⁰¹ Other commentators have argued that interLATA rates in the New York/New Jersey corridor demonstrate that BOC entry into in-region, interLATA markets will foster competition. See *Direct Testimony of Dr. William E. Taylor on Behalf of BellSouth Long Distance, Inc.*, Before the South Carolina Public Service Commission, Docket No. 97-101-C, page 18. This reasoning is flawed. Although customers can presubscribe to Bell Atlantic/NYNEX for Eastern corridor calls, they must then dial a 10-XXX carrier access code for interLATA calls outside the corridor. Consequently, very few customers have presubscribed to Bell Atlantic/NYNEX, and most Eastern corridor Bell Atlantic/NYNEX intraLATA calls require an access code. These obvious competitive handicaps, and not greater efficiencies, have forced the BOC to lower its interLATA rates.

markets -- is the regulatory restriction embodied in Section 271 of the 1996 Act. Once this restriction is relaxed, BellSouth can rapidly enter long distance services, leasing bulk transport facilities in competitive long distance wholesale markets. In contrast, entry by an IXC into local service will depend on the successful implementation of the Section 251 unbundling provisions of the Act. We do not yet know whether these will be successful in eliminating the significant economic entry barriers that confront firms wishing to compete with BellSouth in local service markets.

F. In Summary, While Benefits From BellSouth Entry into Long Distance are Likely to be Small, Benefits of Increased Local Competition are Likely to be Large

139. In summary, therefore, prices in long distance markets approximate economic costs. Because long distance markets are already effectively competitive, entry by an additional firm -- even BellSouth -- will not have a significant effect on long-run prices. In contrast, however, one should expect significant gains from introducing competition to local services.

VI. RESPONSE TO CLAIMS OF JERRY A. HAUSMAN

140. Professor Hausman makes two main points in his declaration.¹⁰² First, BOC entry into long distance will reduce long distance prices significantly, yielding economic benefits to residential customers of \$7-\$10 billion dollars per year.¹⁰³ Second, if BOCs are

¹⁰² See *Declaration of Jerry A. Hausman on Behalf of BellSouth*, note 5, *supra*.

¹⁰³ See *Declaration of Jerry A. Hausman on Behalf of BellSouth*, note 5, *supra*, page 2. This represents a significant increase in the total benefits estimated by Professor Hausman of \$6-\$7

permitted to enter long distance markets, then incentives for local entry are enhanced as both BOCs and interexchange carriers will want to offer "one-stop shopping" to residential customers. We refute these claims below.

A. BOC Entry and Local Competition

141. As our analysis presented in Section III.A makes clear, long distance markets are already effectively competitive. Hence, little long-term gain in economic efficiency in the form of benefits from lower long distance prices is possible. Professor Hausman's justification for the claim of lower long distance prices is founded both on a theoretical argument and in his analogy to pricing by Southern New England Telephone (SNET) in Connecticut, GTE in California, and to recent offers by Qwest in conjunction with the RBOCs.¹⁰⁴ This reliance is misplaced.¹⁰⁵

billion per year in an earlier proceeding (see *Affidavit of Jerry A. Hausman on Behalf of BellSouth, in the Matter of Application of BellSouth Corporation, BellSouth Telecommunications, Inc., and BellSouth Long Distance, Inc., for Provision of In-region, interLATA Services in South Carolina, Before the Federal Communications Commission (October 1997), refiled in the Matter of Application of BellSouth Corporation, BellSouth Telecommunications, Inc., and BellSouth Long Distance, Inc., for Provision of In-region, InterLATA Services in Louisiana, Before the Federal Communications Commission (November 1997)*).

¹⁰⁴ According to Professor Hausman, "overall SNET residential prices were about 17.3% less than AT&T's on average" (see *Declaration of Jerry A. Hausman on Behalf of BellSouth*, note 5, *supra*, page 9). Related arguments about the experience with SNET in Connecticut are presented by Professor Gilbert (see *Affidavit of Richard J. Gilbert on Behalf of BellSouth*, note 7, *supra*, pages 19-21) and by Professor Schmalensee (see *Declaration of Richard L. Schmalensee on Behalf of BellSouth*, note 6, *supra*, pages 31-35).

¹⁰⁵ In his independent examination on behalf of the Department of Justice, Professor Marius Schwartz has reached the same conclusion. According to Professor Schwartz, because Hausman

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142. First, Professor Hausman argues that, according to economic theory, a BOC would have an incentive to lower long distance prices because of the "double marginalization" effect.¹⁰⁶ His analysis is flawed because it assumes long distance markets are not already competitive, contrary to the evidence we presented earlier. Furthermore, his theoretical discussion fails to consider the adverse effects of BOC entry into long distance markets on the emergence of local competition and local pricing.

143. Second, Professor Hausman, as well as Professors Gilbert and Schmalensee, seek to justify their prediction on entry resulting in lower long distance pricing by presenting a misleading picture of the competitive impact of SNET on Connecticut telecommunications markets. First, the major IXC's offer nationwide rates that are comparable to SNET's long distance prices.¹⁰⁷ SNET's interexchange rates range from 23 cents during the day to 13 cents

"fails to consider lower rate plans offered by AT&T and other IXC's" and ignores the fact the customers on discount plans account for the highest share of long-distance expenditures, "the rate reductions predicted by Professor Hausman based on his interpretation of the SNET and GTE experiences overstates [the potential for welfare gains] substantially." *Supplemental Affidavit of Marius Schwartz*, ¶¶ 81-83, *supra*, note 84.

¹⁰⁶ See *Declaration of Jerry A. Hausman on Behalf of BellSouth*, note 5, *supra*, pages 6-8. The double marginalization effect occurs when an upstream monopolist prices above cost to a downstream monopolist, which also prices above cost. The upstream mark-up leads to reduced downstream demand which results in higher downstream prices and lower total welfare than in the case with a single vertically integrated monopolist.

¹⁰⁷ See *Affidavit of Lee L. Selwyn, Susan M. Gately and Helen B. Golding on Behalf of AT&T Communications of California, Inc.*, paragraph 7, attached as Attachment 3, hereto.

at night (or a flat 15 cent flat rate), and only provide small discounts for high volumes.¹⁰⁸ In comparison, AT&T One Rate and Sprint Sense Day Plan each offer flat rates of 15 cents a minute to all customers, at all times, regardless of calling volumes. Further, AT&T offers a 10 cent flat rate for a \$4.95 monthly fee. Sprint also offers a flat rate of 10 cents per minute for domestic calls between 7 P.M. and 7 A.M., and 25 cents for other domestic calls. It is also currently offering \$50.00 a month in free calls on Monday evenings. MCI also offers a competitive flat rate: 12 cents a minute at all times to customers who make over \$15.00 a month in calls. Further, it offers all residential customers a 5 cent per minute rate on Sundays. Plainly, there is no obvious consumer benefit flowing from SNET's entry into the interexchange market.

144. Professor Hausman criticizes our analysis with respect to BellSouth's previous application for a failure to "analyze SNET's prices for a range of residential customer usage patterns and compare them to AT&T's prices." This is a red herring. The key issue for consumers -- what services and prices are available in the marketplace -- does not involve simply a comparison of AT&T's and SNET's pricing, but rather requires an examination of all the competitive offerings in the interLATA market. Indeed, as Lee Selwyn, *et al.* demonstrate, the long distance carrier that offers the lowest average price per minute varies

¹⁰⁸ Although Professor Hausman maintains that "SNET offers a discount of 10%-15% off the \$0.15 per minute price depending on monthly calling volume"(see *Declaration of Jerry A. Hausman on Behalf of BellSouth*, note 5, *supra*, page 9), according to SNET sales representatives, subscribers to SNET's 15 cent flat rate plan are not eligible for any volume discounts.

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across different customer usage scenarios. Thus, while SNET and AT&T are found to be the low-price provider for some usage scenarios, they are not so for all.¹⁰⁹ The crucial point, as Lee Selwyn, *et al.*, show, based upon examination of various usage scenarios, is that "SNET's entry into the interLATA market in Connecticut . . . did nothing to lower the level of prices for long distance service overall, and produced no special 'enrichment' for Connecticut consumers."¹¹⁰ This result confirms our finding that the interLATA market is characterized by competition.

145. Professor Hausman also asserts that in our previous analysis we failed to explain how SNET could capture its market share, if the long distance market were as "vigorously competitive" as we claim.¹¹¹ Although SNET has captured 35 percent of subscribers, its market penetration as measured by its percentage of interLATA toll revenues has been limited and, as of the third quarter of 1996, appears to have leveled off at about 11 percent.¹¹² Given SNET's marketing advantages of one-stop shopping and pre-existing brand name, such limited penetration corroborates the interLATA market's high degree of competitiveness.

146. Moreover, SNET's ability to capture market share is not attributable to any

¹⁰⁹ See *Affidavit of Lee L. Selwyn, et al., on Behalf of AT&T Communications of California, Inc.*, note 107, *supra*, paragraph 15.

¹¹⁰ *Ibid.*

¹¹¹ See *Declaration of Jerry A. Hausman on Behalf of BellSouth*, note 5, *supra*, page 24.

¹¹² See *Declaration of Richard L. Schmalensee on Behalf of BellSouth*, note 6, *supra*, paragraph 62.

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greater efficiencies. Rather, SNET's success is due to its bundling of long distance offerings with its monopoly provision of local services, and to its aggressive promotion of PIC freezes for its own long distance customers. Furthermore, through a recently announced corporate reorganization, SNET has attempted to rid itself from the Act's requirement that it resell local services at a wholesale discount.¹¹³ Thus, contrary to Professor Gilbert's, Professor Hausman's and Professor Schmalensee's contentions, the SNET experience does not prove the benefits of permitting a monopoly ILEC into an in-region, interLATA market. Rather, SNET's behavior illustrates precisely what an ILEC will do to avoid opening its market to competition.

147. Moreover, Professor Hausman provides no evidence that any price discounts that may exist are likely to be long-term, which is the appropriate basis for computing the welfare benefits that he claims.¹¹⁴ Both SNET and GTE are monopoly providers of local

¹¹³ See *AT&T v. Commissioners of the Connecticut Dep't of Pub. Util. Control*, Civ. Action No. 397CV01601, Complaint for Injunctive Relief and Declaratory Judgment, ¶ 9 (filed Aug. 8, 1997).

¹¹⁴ Professor Hausman's argument that a BOC entrant would prefer lower long distance prices assumes that the BOC has no ability to hamper the competitiveness of IXC's through such non-price means of access discrimination and that the BOC could capture significant market share only with significant reductions in price.

The latter assumption is challenged by Professor Marius Schwartz, who argues that a BOC's increase in profit from expanding access minutes (the channel emphasized by Professor Hausman) is likely to be considerably less than its profit from retail long distance sales. In this case, an increase in a BOC's share of interLATA revenues could be obtained by diverting business from IXC's rather than by expanding output. See *Supplemental Affidavit of Marius Schwartz*, note

service. As such, they have a clear incentive to protect and extend their market power. They currently receive substantial subsidies in the form of interexchange access charges and revenues from other local services with prices that greatly exceed costs (*e.g.*, prices for business lines, vertical switch features, etc. are generally accepted to be significantly above economic costs¹¹⁵). Furthermore, SNET and GTE have an incentive to use these subsidies to cross-subsidize their efforts to acquire future "one-stop shopping" customers, which will increase economic entry barriers faced by CLECs seeking to compete in their markets.

B. One-Stop Shopping

148. While we agree with Professor Hausman that one-stop shopping is a desirable feature for residential customers, consumer choice in one-stop shopping is not possible until local markets become more competitive. Indeed Professor Hausman appears to define the public interest intent of the Telecommunications Act of 1996 narrowly by focusing solely on the effect of BellSouth's entry on long distance services. As we argued earlier, BellSouth's entry into interLATA services before the emergence of effective local service competition is likely to harm the competitive process in both local and long distance markets. Indeed, the

84, *supra*, pages 28-29.

¹¹⁵ BOC respondents argue that pricing access, business, and vertical feature services above cost is necessary in order to recover the costs of providing service to residential customers at rates that are below costs. While no one disputes that access and a large class of services are priced significantly above costs, the BOCs have not been able to demonstrate that service to the average residential user requires a subsidy.

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potential welfare losses from delaying the emergence of local competition are likely to be very large. This is true because the reduction in prices is likely to be very significant (because local services are an effective monopoly today), because local access service is an essential input for long distance, and because the local market is an order of magnitude larger. As noted earlier, we have estimated that introducing effective competition into local telephone services would produce benefits that may exceed \$19 billion,¹¹⁶ which is more than twice the amount estimated by Professor Hausman from reducing long distance prices by over 17 percent.¹¹⁷

149. Professor Hausman's arguments fail to convince because they neglect to adequately consider the full impact on the overall price that consumers will pay for "one-stop shopping." Long distance services are only part of the bundle. If reduced prices for long distance services in the short-run are paid for by delaying progress towards sustainable lower prices for local services then consumers will be harmed and the public interest will not be served. Competition that allows consumers a choice among suppliers for their one-stop

¹¹⁶ See R. Glenn Hubbard and William Lehr, *Improving Local Exchange Competition: Regulatory Crossroads*, *supra*, note 21.

¹¹⁷ Even if one accepts Professor Hausman's argument that prices currently exceed incremental costs in long distance markets, the 17 percent reduction on account of BOC entry is almost certainly too high. First, Hausman does not provide supporting data for how he computed the 17 percent differential, which must depend on an estimate of AT&T's actual traffic mix by pricing plan. Second, Hausman applies the 17 percent figure to all interLATA revenues from residential customers even though not all of the interLATA minutes originated in BOC service areas. The BOC's impact on competition in interLATA markets will be much less in regions already served by GTE or SNET, for example. Curiously, as we noted earlier, the high alleged profitability of interLATA markets has lured few attempts at out-of-region entry by BOCs.

shopping services offers the surest mechanism for guaranteeing that prices for both local *and* long distance services are as low as possible.

150. Professor Hausman would have us believe that the benefits of lower prices for long distance services in the short run and the rapid delivery of a single "one-stop" shopping alternative to consumers outweigh any costs remaining from barriers to local entry. While striving for regulatory perfection is not likely to be efficient, one cannot simply ignore -- as Professor Hausman does -- the welfare gains to be obtained from greater local competition. As we noted above, the welfare gains from greater local service competition in BellSouth's territory are plausibly much larger than any speculative welfare gains from BellSouth's entry into in-region, interLATA services.

151. Professor Hausman argues that allowing the ILECs to enter interLATA services would increase the incentives of IXC's to compete in local services.¹¹⁸ The desirability of integrating into local services in order to offer "one-stop shopping" is well understood. The Telecommunications Act of 1996 recognized that entrants face formidable economic entry barriers in competing with an ILEC in its home market, and hence, the Act required network unbundling at cost-based rates so as to place the ILEC and CLECs on an equivalent footing with respect to essential inputs. The CLECs do not need improved incentives for entering local services (which they already have); rather, they need the opportunity to avail themselves

¹¹⁸ See *Affidavit of Jerry A. Hausman on Behalf of BellSouth*, note 5, *supra*, page 4.

of the pro-competitive policies that are guaranteed under the Act. Permitting the BOCs to enter interLATA services at this time will harm rather than help prospects of successfully implementing the network unbundling provisions of the Act.

VII. RESPONSE TO CLAIMS OF RICHARD L. SCHMALENSEE

152. Professor Schmalensee¹¹⁹ offers three principal conclusions in his declaration. First, residential long distance markets are inadequately competitive. Second, BellSouth's low incremental costs and good marketing position make it a credible competitor in the interexchange market. Third, carrier access rates above cost will not harm competition. We address these points below.

A. Imperfect Competition in Long Distance

153. We addressed earlier the wealth of evidence that contradicts Professor Schmalensee's assertion that long distance markets are inadequately competitive. He argues that prices have failed to reflect fully the decline in access charges that has occurred since 1991, and that this is sufficient to demonstrate that long distance markets are not adequately competitive. First, access charges are an important input cost, but they are not the only input cost. Increases in other cost categories such as marketing-related costs or uncollectibles may offset any savings associated with reductions in access charges. Second, changes in tariff prices provide only a noisy and inappropriate estimate of changes in average revenue per

¹¹⁹ See *Declaration of Richard L. Schmalensee on Behalf of BellSouth*, note 6, *supra*.

minutes (ARPM), which offers a superior summary statistic for assessing price trends. There may be changes in demand patterns that make it difficult to associate reductions in access charges directly to changes in tariffed prices. If one insists on considering patterns in tariff prices, then it is more informative to consider the least-cost options for delivering service to each category of consumer (see Figure 5). Third, as we noted earlier, ARPM net of access declined for AT&T, which refutes Professor Schmalensee's principal assertion.

154. Professor Schmalensee is also incorrect in asserting that the patterns of market share changes in long distance imply the existence of tacit price collusion.¹²⁰ He appears to be arguing that there are stable market shares in long distance markets and that is conducive to collusion. As a matter of theory, of course, evidence of stable market share is thought of as a potential *consequence* of collusion, not as a *precondition* for collusion. In any event, AT&T has continued to lose market share since 1989, and the loss in market share has not been captured entirely by MCI and Sprint. Furthermore, the significant churn in market shares discussed earlier provides evidence of the vigorous nature of competition in long distance markets. Moreover, there is an obvious reason that long distance is not conducive to a collusive stability of market shares. Currently, long distance carriers cannot avoid competing for each others' customers. That is, they have no natural way to divide the market. By contrast, a BOC entrant such as BellSouth would have a natural means of dividing the market

¹²⁰ See *Declaration of Richard L. Schmalensee on Behalf of BellSouth*, note 6, *supra*, page 7.